RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

Since 1958

Post Office Box 1759, La Jolla, California 92038 17 Letters Per Year • $250 annually www.dowtheoryletters.com

**April 25, 2001** **LETTER 1317**

**April 6, DJIA 9791.05; PTI 5234; A-D Ratio –5.66**
**April 13, DJIA 10158.56; PTI 5244; A-D Ratio –5.22**
**April 20, DJIA 10579.85; PTI 5256; A-D Ratio –4.80**
***Dow Times Book Value: +6.46**
***Percentage of Undervalued Blue-chips: 8%**
***Gold 34-day MA: 262.9 Dow yield: 1.62; Dow p/e: 22.7**

**THE PICTURE**: On April 18 the Fed moved out of character. Up to now the Fed has had a policy of not surprising the market. If the market was saying rates should be reduced by half a percent, then at the next meeting the Fed would obligingly drop rates by half a percent.

The talk was that the Fed was always "behind the curve," but in time the Fed would follow what the market wanted and what the market was predicting.

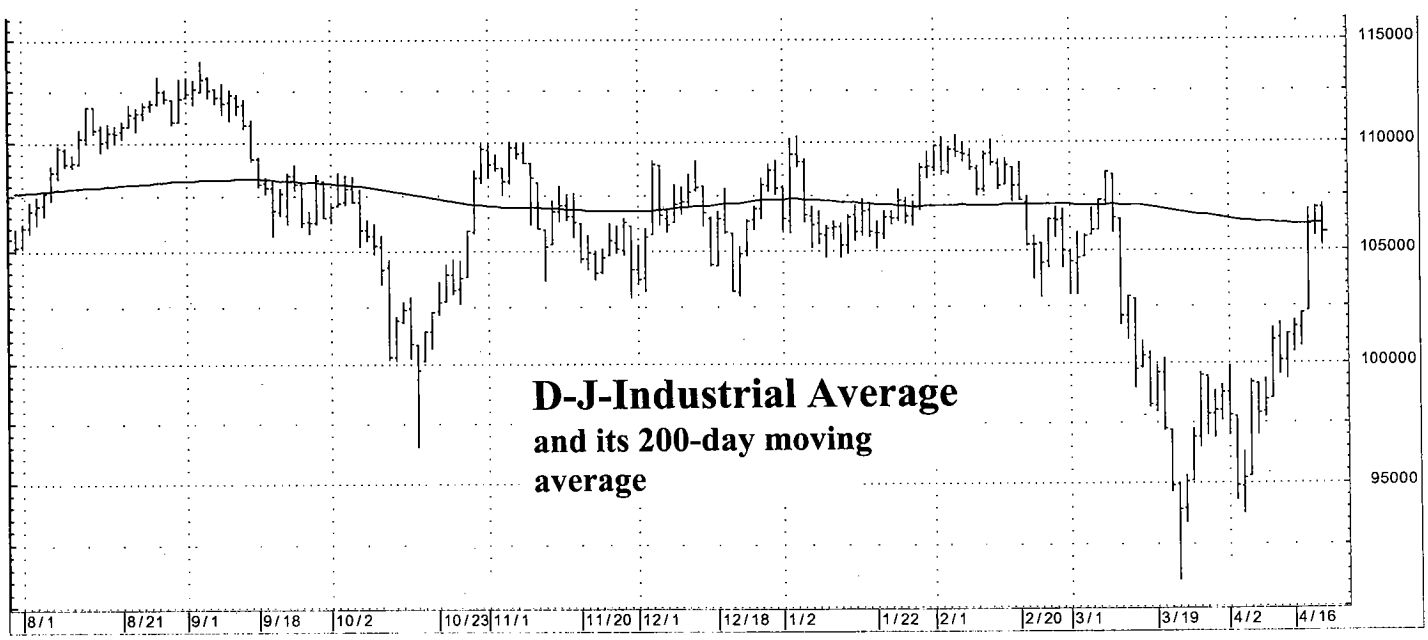
With the stock market moving up over the last few weeks, it was thought that the Fed at its coming May meeting would not drop rates at all – or if they did move to drop rates, the reduction would be at most a quarter of a percent.

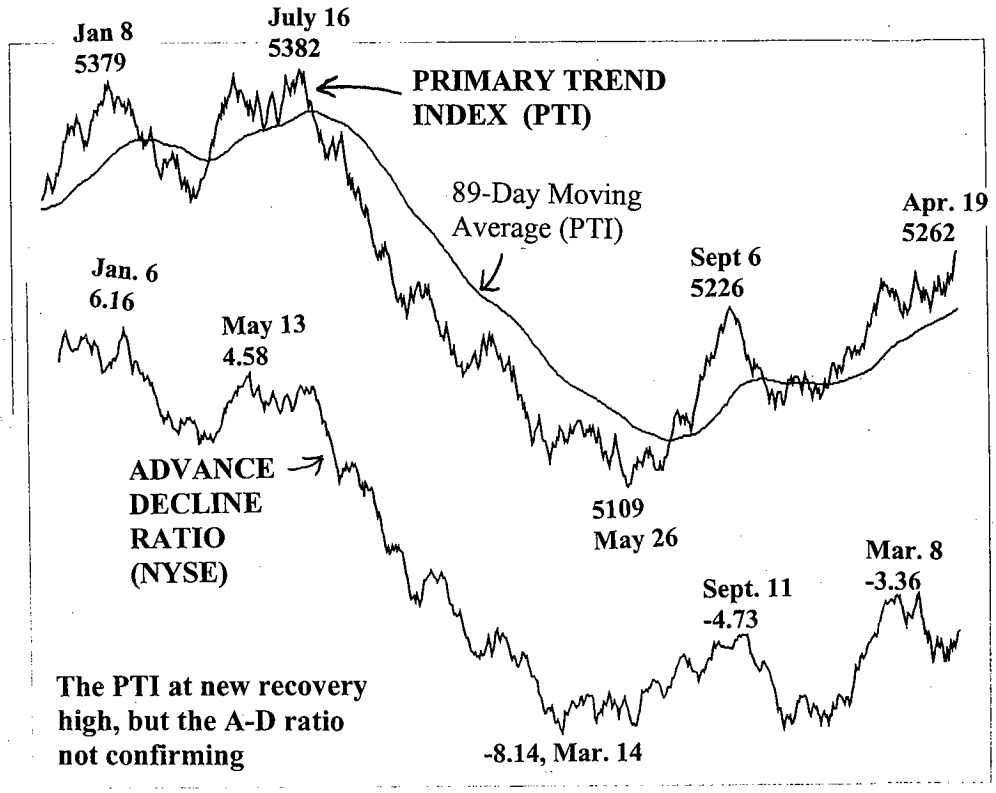
But on April 18 the Fed suddenly surprised Wall Street -- it dropped the rate a half percent, and that was a major surprise. Was the Fed panicking, was the Fed just sticking a knife into the guts of the shorts, or was the Fed just trying to make certain that the nation wasn't sinking into recession?

We'll probably never know exactly why the Fed made the move. But it seemed clear that the Fed was taking no chances. It absolutely does not want to take a chance that the economy will sink into a definite, clear recession.

What the Fed's action amounts to is – bringing back "the excess." You see there's a problem. The S&P (this is the average that the pros watch) is selling at three times revenues, 24 times earnings, nearly six times book value and with a minuscule dividend yield of 1.2%. By any standard, this is the most overvalued S&P in history. Its overvaluation dwarfs the overvaluation that existed in 1929, 1937, 1946, 1966, 1971 or 1987. And that's a problem that Fed manipulation and stimulation can't solve.

Bear markets exist for the purpose of correcting the excesses of the preceding bull market. But the Fed, by its actions, is saying "There can be no correction. There can be no bear market." With a chronically negative trade balance, with consumers up to their necks in debt, with corporations choking on debt, with consumer savings negative, the nation can't take a chance on an economic correction. The nation can't take a recession.






Over and over again Greenspan has flooded the banking system with liquidity at each crisis from the collapse of a hedge fund to the possiblity of a Y2K catastrophe. Serious market and economic students wonder how long this reliquefying process can go on. They wonder how long the dollar can hold up under these Fed policies.

At any rate, the Fed has taken its stand. And the market will have to deal with it in its own way.

I've written repeatedly that I think the current bear market could develop much along the lines of the 1966 to 1974 bear market. By that I mean that we could have a series of mini-bull and mini-bear markets – prior to a final conclusion wherein the bear would totally take over, much as he did during 1971 to 1974.

What we may be seeing now is the first mini-bull market following the collapse of the Nasdaq and the 26% fall in the S&P. **For the Dow please see the section on Market Math**. The fact is that if the Dow had been calculated the way almost all the averages today are calculated, it would have been down 29% rather than the 19% that has been reported by Wall Street's analysts and strategists.

Markets are subject to the same forces as solid matter. For every force in the market there is a counter-force or corrective force. If the market goes too far in one direction, it will tend to correct by moving back toward equilibrium.

But what is equilibrium? The time-honored measure of equilibrium has been the 200-day moving average. I had written on my daily Web site that the major averages had dropped "too far" below their 200-day moving averages, and that this should call for a correction.

And that's what I believe we're seeing. On page 1 of this report I show a chart of the Dow in relation to its 200-day moving average.

As I see it, this is a classic picture of a bear market correction in which the shorts have been slaughtered. It's also a perfect picture of why I have always warned subscribers to resist shorting a bear market. The upside corrections can be huge, often looking better than the real thing. It's obvious as you look at the page 1 chart that the shorts have been killed by this rally – certainly the giant upside move (on the day of the Fed's announcement) pinned the shorts against the wall.

Note that the rally was so powerful that in a single day it drove the Dow above both its 50-day and 200-day moving averages. It also drove the Dow above the 10550 or the halfway level of the entire decline from the high.

I'll be most interested to see whether the Dow can hold above the 10550 level and also above the level of its 200-day moving average (the 200-day moving average stands at 10615.)

**MARKET MATH:** The Dow isn't structured the way most of the other leading averages are. For instance, the S&P 500 and the Nasdaq are weighted for market capitalization. And ironically, even the modern indices that Dow Jones has created recently (foreign markets) are weighted for capitalization.

But the Dow was created by Charles Dow back in 1896. Dow didn't have computers, so he simply added up the price of the stocks in the Industrial Average and divided by 30. Except for adustments for splits and mergers, that's the way the Dow is computed today.

Market cap indexes are based on the market value of a company's outstanding shares. But by treating each dollar rise or fall in the price of a stock (regardless of its capitalization) the Dow hides the importance of real market value. Actually, if the Dow was computed for market cap, it would have been down 29% at its recent low (comparable to the loss in the S&P) rather than the 19% that was posted based on the way the Dow is computed.

* *

A study by Thomas Watts of Merrill Lynch shows that when stock prices sink to single digits, the odds are that they are finished – at least for quite a while. Watts studied the trading of 1,900 companies spanning the technology sectors going back to 1985. He found that of companies whose stocks had fallen to single digits, only a minuscule 3.4% rebounded to $15 or higher during the following year. And most of those stocks that didn't bounce back in the first year never did.

Watts got the idea from customers who repeatedly told him that their stocks that had declined as much as 90% "looked cheap." There seemed to be an irresistible lure in buying stocks at $3 or even less. But it doesn't work that way. Two reasons: first, professional managers in charge of mutual funds are often barred by their firm's bylaws from buying stocks that sell for below $15. Second, many low-priced stocks can't get the financing they need. The low price scares investors away.

Watts notes that of the 437 companies that became single-digit companies in 2000, only five have returned to double digit in 2001 – that's less than 1.1%.

* *

Investors often get confused in bear markets because the math in bear markets doesn't work the way it does in bull markets. Very simply, if your stock drops 50% in a bear market, to get your money back your stock will have to climb 100%.

For example, the Nasdaq dropped about 68% from last year's peak of 5048. But it takes a lot more than a rally of 68% for the Nasdaq to get back to its high. To get back to its high, the Nasdaq would have to climb more than 170%.

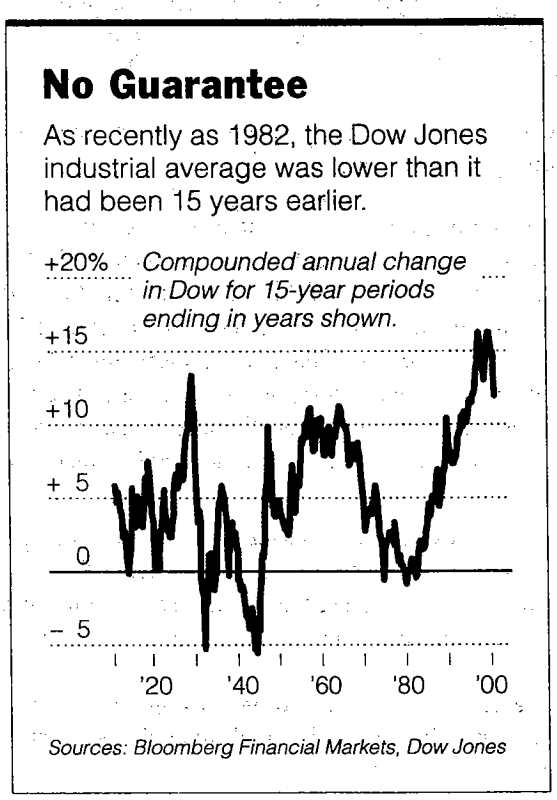
Note that CNBC and many other sources continue to talk about a stock's climb in percentages. But this can be misleading and frustrating. Example: you buy a stock for $50. In the bear market it drops to $2 -- you've lost $48 plus commissions.

Then you hear on CNBC that your stock has risen 50%. That's fabulous, your stock is up 50%. But what does that mean? It means your stock which has dropped from $50 to $2 and now up 50% -- is selling at $3. Big deal -- your stock is up 50% but it's still miles away from recovering.

Or take an actual example such as Priceline. Two weeks ago the stock rose 2.3% in a single day. Great, the stock is now worth $3.07. But it only needs a 2,471% rise to get back to its high. So the odds are that the stock will never get back to its high.

* *

This is a fascinating chart that appeared in the April 12 *New York Times*. Let's assume that "the long haul" is about 15 years. This chart shows annual changes in the Dow for consecutive 15-year periods.




The New York Times

Note that starting in 1980 we had an absolutely unprecedented run where stocks rose in each 15-year period, a rise that ended around the year 1999. There has never been a series like this before, going back to almost the turn of the century.

I would expect this annual change "index" to head down during the period ahead. If over the next 15 years the Dow (compounded) does nothing, the "index" will decline to zero. The fact that the index is now at a record high strongly suggests that at the end of the next 15 years the Dow will probably have produced few, if any, gains.

Why is this? It's because stocks are now so overvalued that it will take a long time before stocks and the economy catch up to the current prices.

Of course, this index does not have to come all the way down to zero or below. But the index does appear to have topped out, meaning that it will be heading down from its highest peak in history.

**CYCLES:** As subscribers know, I've never been "big" on cycles. However, there are two cycle items that I watch and give credence to.

The first cycle I watch is the period from October to April and the period from April to October. For whatever reason (and I believe Yale Hirsch discovered this) most of the stock market advances and profits have come during the October to April period. And for whatever reason, most of the trouble and losses in the stock market have come in the April to October period.

As we are now in the April to October zone, this is a negative period for stocks.

The second cycle period I want to mention was discovered by my old friend and stock market maven, Robert Powers. Writes Powers, "Since 1802 the real 'inflation adjusted' total return in the US stock market has averaged 7.08% a year. If one looks at annual data, there have been seven 'strong cycles' since 1802, where the median annual real return has been 14.0%. And there have been seven 'weak cycles' where the median annual total return has been 0.0%.

"The strong cycles have lasted 17 years on average, while the weak cycles have averaged 16 years. From 1892 to 1999 we have experienced a strong cycle with the average annual total return for that time period being 14.9%.

"The table below depicts these strong and weak cycles, showing the time periods, real annual total return, and duration."

**Russell Comment:** This is outstanding and extremely important research. According to Powers' research, we are now moving into the weak cycle period. This corresponds with the current overvaluation in stocks and the gathering bear market.

When the P/E for the S&P is above 22, the median annual return for the stock market has run 5%. But these figures were developed when the dividend yield on the S&P was considerably higher than the 1.2% that exists today. Historically, dividends have comprised up to 50% of the annual total return in stocks. (Robert Powers, PO Box 35, Rapid City, MI 49676).

| Weak Cycles---------- | | |
|---|---|---|
| 1802-15 | +2.7% | 13 years |
| 1835-43 | -0.6% | 08 years |
| 1853-61 | -3.0% | 08 years |
| 1881-97 | +3.9% | 16 years |
| 1902-21 | +0.0% | 19 years |
| 1929-49 | +0.8% | 20 years |
| 1966-82 | -1.4% | 16 years |

| -Strong Cycles------- | | |
|---|---|---|
| 1815-35 | +10.0% | 20 years |
| 1843-53 | +13.7% | 10 years |
| 1861-81 | +12.0% | 20 years |
| 1897-02 | +15.2% | 05 years |
| 1921-29 | +25.2% | 08 years |
| 1949-66 | +14.0% | 17 years |
| 1982-99 | +14.9% | 17 years |

**NOTES & QUOTES**: The recriminations are now coming in. How did we miss it, how could we not see that this was a bear market? And what about all those people who told us to buy at the top and then when our stocks collapsed, they told us to sell at the bottom.

The April 2 issue of *New York* magazine features an article about Paul Krugman, the angry columnist who first "took down" the patron saint of the market, Alan Greenspan. The article starts, "Paul Krugman, the *New York Times'* op-ed columnist on economic matters, thinks Alan Greenspan is the biggest idiot since whoever it is who runs the Bank of Japan (surely the world's greatest idiot). Almost all the ringleaders of the boom are in a similar image free fall. Goldman analyst Abbey Joseph Cohen, the prim, no-nonsense optimist with the pioneer-lady look, still predicting the Dow will go to 13,000 is a ridiculous figure now. Morgan's aggressive and implacable Mary Meeker seems almost demented. . . as for Greenspan, until a short while ago he was a God, for all secular purposes. Now he's a boob."

And from *Newsweek* April 9 – "Once upon a time investors had rules. Buy and hold, buy what you know, buy blue chips. This was how you matched the market's historical returns of 11% a year. Only 11%?

"As the market spent the last half of the '90s spiraling upward, the traditional wisdom was shouted down. 'The business cycle has been abolished!' cried the apostles of the New Economy. 'Day trading works!' they said. 'Don't ask if companies make money! You don't get it, was the message to naysayers, the Internet has changed everything, and you don't get it.'"

From *Business Week* (April 9), an article entitled, "Too Much of Everything." And the article warns, "In the go-go years of the late 1990s, all things seemed possible. They threw up plants, bought equipment, and staffed every department from sales to service as though the good times would never end. But, of course, now they have. Companies throughout the economy, in high tech and low, are scurrying to adjust by cutting spending and laying off workers. After years of frantically investing to build up the human and physical capacity to keep up with soaring growth, the US economy is struggling with overcapacity as far as the eye can see."

* *

The Europeans are trying to capture the US's retailing. Apparel retailer French Connection has set up shop in many US malls. Hennes & Mauritz, Europe's biggest clothing retailer is hitting the malls with its cheap knock-off designer clothes and the prices are low. Americans are flocking in to load up on European merchandise. The retail "wars" are on.

* *

The US is the arsenal of democracy, the world's only super-power – but then why does the world hate us? Partly it's jealousy, partly it's fear of our power.

But there could be reasons. I quote from the *Donald R. Morris Newsletter,* "We penalize behavior we don't like with sanctions. At the U.N. we're behind on our dues, but we dictate reforms and pushed out a secretary-general. We decide who can join NATO; we opted out of a treaty banning land-mines, refused to ratify another banning land mines." And look at this headline from the April *2 New York Times:* "Bush Angers Europe by Eroding Pack on Global Warming."

As Morris sums it up,"Why should anyone like us?"

* *

Want to gamble in the world's best climate? Come to San Diego, where the Indians rule. The fourth Indian casino opened in San Diego County two weeks ago. It's the 185,000 foot Pala Casino, replete with 2000 Las Vegas-style slots and video games, 46 table games, six restaurants and an events center seating 2000. San Diego County is reputed to have more Indian casinos than any other region in the nation. The county has four casinos with three more casinos built by the San Pasqual, Pauma and Rincon Indians on the way. By 2010 it is estimated that California could have as many as 100 casinos.

A recent study by Applied Economics estimates that Nevada could lose $24 to $43 million in revenues and up to 16,000 jobs because of California casinos. And the Indians are using professional builders and managers. For instance, Las Vegas based Harrah's will help develop and manage the Rincon band's $100 million hotel and casino to open early next year. Las Vegas is preparing for the squeeze -- and the Vegas casinos know that "if you can't beat 'em, join 'em."

* *

This from Arch Crawford's always interesting "Crawford Perspectives" (520 577 1158). "The Plunge Protective Team was the unoffical arm of government, consisting of Fed head, Treasury, a New York Fed chair and a very few 'discreet' others. Whenever the Dow Industrials were down over 200 points after the bonds closed at 3PM Eastern, one or more of these gentlemen would appear on your CNBC or CNN screen, and the market would jump 100 points in the next five minutes. This is not rumor, this is my observation!"

**Russell Comment:** Yep, I've noticed the same thing, and I've also noticed that the Dow never closes at its exact low for the session – somebody or some group always puts a little upside "tail" on it so the CNBC crowd can say that the "Dow closed off its lows."

* *

What's happening to our men? For every 100 girls under 20 there are 105 boys. But at ages 20-44, for every 100 women they are only 98 men. Talk about attrition.

* *

There are six thousand languages spoken today, with the greatest percentage of these actually moribund, spoken by a few remaining oldsters. Thousands of languages have disappeared over recent millenia due to speakers being conquered or exterminated by dominant groups. By the end of the century, writes the *Natural History* magazine, the world may be down to as low as 200 languages. English is the world's major "second language." It's the international language of business and the language of the Internet.

* *

The following from the excellent Klein-Wolman Investment Letter (609 588-9168). "The US economy is a service economy. Service employment has continued to grow. That's the good news. The bad news is that service prices are also growing. Services make up 58.2% of the CPI while goods or commodities make up 41.8%. Over the past year, the service component of the CPI increased by 4.5%. Goods prices have been contained. Service prices have not been contained and post a serious problem for the Federal Reserve."

**NO DIVIDENDS:** You buy a stock for 60 dollars, you hold it for five years, and it's never paid a dividend. A bear market hits, and you end up selling the stock for 30 dollars. What have you got? A dead loss with never a hint of a return. Not my cup of tea.

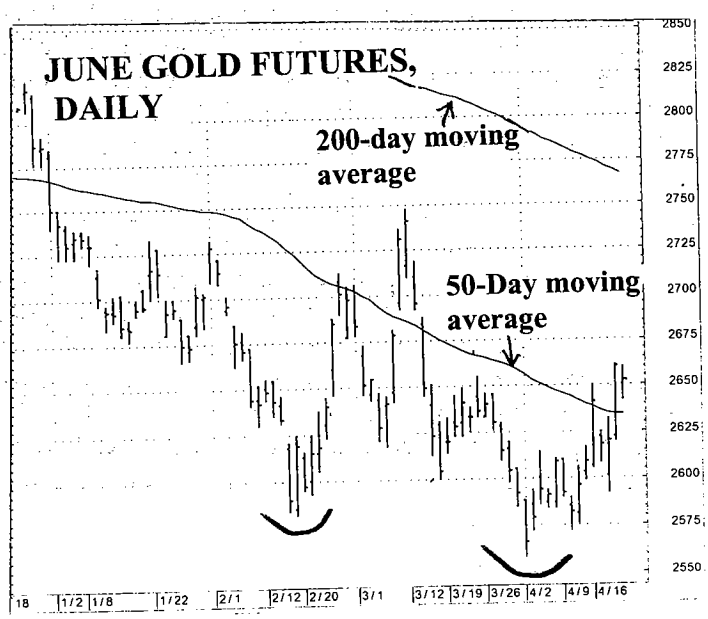
Overvalued stocks with no dividends. Talk about high risk. People just don't understand this kind of reasoning. But they will before this bear market is over.

I just received the latest "Economics and Portfolio Strategy" report from Peter Bernstein. Peter actually wrote the book on risk ("Against the Gods, the Remarkable Story of Risk"). In his report, Peter writes:

*Dividends these days are becoming increasingly difficult to come by. Fewer companies are paying dividends and even famous, long-established companies are cutting their dividends. Hence, dividend growth is diminishing rapidly (the dividend on the S&P 500 was actually shrinking at the end of 2000 on a year/year basis). This combination reveals more than the lofty level of stock valuations. Low cash flow to shareowners is equivalent to high risk, because low cash flow means long duration; no dividends means infinite duration. When cash flow to shareowners is a trickle, you are left to depend on what some other investor –without your interests at heart – will pay you one day in the uncertain future for what you happen to own. High risk and low return? No thanks."*

**GOLD:** Is something happening in gold, the forgotten metal? We know that the Comex stock of gold is very low now, in fact the Comex could be literally running out of gold.

But that's just another interesting fundamental. The price, the price, the price tells all. The chart shows the action in the June gold futures. From an extreme low of 255.80 on April 3, June gold rallied to an intraday high of 266.10 on April 19. The April 19 surge took gold above its 50-day moving average, which was a hopeful sign for gold-philes.




But to look "good," gold has a lot of work to do. The first really impressive action would be for June gold to rally above its March 12 high of 274.80. That is a far cry from gold's current price.

XAU, the Phila. Gold/Silver average, has also been climbing and its 50-day moving average has now risen above its 200-day MA for the first time this year. XAU's upside target is its March 9 peak of 57.42. If XAU can get above 57.42, gold will be on its way. If, if, if –

**LATE NOTES:** At this point we find the Fed fighting the bear with all the weapons at its command. The Fed won't remedy what ails the economy, the Fed won't reverse the tidal bear trend – but the Fed can EXTEND the bear market, pushing its conclusion out further and further. In so doing, however, the Fed will simply worsen the situation. Instead of allowing the economy and the market to fully correct, the Fed, with its manipulations, will simply "bring back the excesses" that the bear is attempting to correct.

From a technical standpoint, it will be important to see whether the Dow can move above the **halfway or 50% level** of the entire bear market decline (11722 to 9389). The 50% or halfway level is **10550**. If the Dow can rally above the 10550 level, and then hold stubbornly above that level, it will be a positive technical achievement and will shift the odds in favor of the Dow testing its record high of 11722.

In the meantime, the dollar is starting to break down, while the euro is beginning to climb. How would a declining dollar affect the other markets? Good question – there are two possibilities. The positive would be that a lower dollar would help US exports (make our US exports cheaper in the world market).

The second and negative possibility would be that a lower dollar could frighten foreign holders of US securities. If the dollar declines persistently, such action would definitely frighten foreign holders, and it could cause them to start selling their holdings of US securities. This, in turn, would mean pressure on US stocks and bonds.

**INVESTMENT POSITION:** I'm putting this at the end because I really haven't a lot to say (I think I've said it all before). If I had room, I'd put the bear in the box but I don't have room this time. Get in T-bills, get in money market funds, and stay away from the bear. He's out to grind you up and spit you out. Play around with this market long enough and you'll end up like the inveterate gambler in Las Vegas – you'll be losing your shirt and unfortunately, you won't be any smarter when it's over than when you started.

**NEXT MAILING: May 16, 2001**